BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF BLACK MOUNTAIN SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.

Docket No. SW-02361A-05-0657

REPLY BRIEF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") replies to Black Mountain Sewer Company's ("Black Mountain" or "Company") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as follows.

SCOTTSDALE CAPACITY

In its Closing Brief ("Brief"), the Company claims that it is the "same entity" that it was ten years ago when Decision No. 59944 was issued, and that nothing has changed that would warrant a change in ratemaking treatment of the capacity of the Scottsdale treatment plant to "the detriment of the company." Brief at 10. In fact, much has changed in the last ten years. The Company's predecessor, Boulders Carefree Sewer Company ("Boulders"), no longer exists. Nor does the loan Boulder's parent company made at the time to Boulders exist. RUCO-11 at 4. The combination of debt and equity utilized to purchase the present company has not been, nor can it be, apportioned specifically to the treatment capacity. There is no longer a nexus connecting the capacity to an operating lease. In short, the "operating lease" continues to be a complete fiction, a point both Staff and the Company are requesting the Commission ignore in its rate making treatment. The Commission should not put blinders on and ignore the change of circumstances and the present circumstances.

Ten years ago, when the Commission issued Decision No. 5944, the Commission approved Staff's recommendation which was based on Staff's desire to not recommend anything that would amend the Commission's previous fair value finding (in an earlier phase of that proceeding). Transcript at 371-372. The Commission's Decision to create a ratemaking fiction was made for procedural convenience which was the result of the rate case procedure that existed at that time. The present application is a new rate case and to suggest that the same circumstances exist at this time is, like the "operating lease," a fiction. The Commission should no longer encourage and facilitate a regulatory fiction to achieve a result (avoiding amending a fair value finding) that is no longer relevant.

Finally, the Company will not be harmed by applying the proper ratemaking treatment. The capacity would be placed into rate base and the Company would earn a return on it. The Company will fully recover the principal portion utilizing RUCO's level of depreciation and amortization, and the Company will have the opportunity to recover the interest associated with the loan as a below-the-line expense that will reduce the Company's income tax liability. RUCO-13 at 9.

The ratepayer, on the other hand, would be harmed by the continued treatment of the capacity as an "operating lease." Ratepayers will continue to be deprived of the credit for that portion of the capacity which ratepayers have already paid. RUCO-11 at 7. While ratepayers are paying for 5% of this plant capacity each year through "operating lease" expense, the "operating lease" methodology never provides credit for the portion of the capacity that ratepayers have already paid for. When the correct ratemaking methodology is used to account for this capacity, that credit is reflected in the Accumulated Depreciation balance that serves to decrease rate base and, in turn, decrease rates. Id. The Commission should reject the Company and Staff's recommendation to treat the capacity as an "operating lease."

ACCUMULATED DEFERRED INCOME TAX ("ADIT")

The Company is critical of RUCO's ADIT recommendation, referring to it as "irrational." Brief at 7-8. Instead, the Company recommends the Commission adopt its positive ADIT balance which it provided to the parties late in the proceeding with nothing on the Company's books or records to support it. Transcript at 387.

RUCO's ADIT recommendation is based on the Company's parent's (Algonquin Water Resources of America, Inc. ("Algonquin")) audited 2004 annual report which disclosed a negative consolidated ADIT balance for Algonquin as a whole. The Company referred RUCO to Algonquin's consolidated return initially when RUCO questioned the Company about its original zero ADIT balance recommendation. RUCO-11 at 10. In

RUCO's experience[1] as well as the Company's, ADIT generally will result in a deferred tax liability - not an asset. Transcript at 109, RUCO-12 at 4. The reason is quite simple – ADIT is a deferred tax, it is still owed and is a liability not an asset. It was not surprising that RUCO was unable to validate the Company's zero ADIT balance recommendation. RUCO considered Algonquin's audited balance sheet which indicated a net tax liability and apportioned a percentage of that ADIT balance based on the ratio of the Company's purchase price to Algonquin's total assets. RUCO – 11 at 11, RUCO – 12 at 5,

The Company did not list an ADIT balance in its financial statements for 2002, 2003 and 2004. Transcript at 261. Fantastically, in response to further data requests submitted by RUCO and then Staff, the Company was able to come up with an unsupported, positive $164,000 ADIT balance specific to the Company (not Algonquin) which Staff adopted as its recommendation. S-9 at 21. It would be irrational for the Commission to adopt the Company and Staff's recommended ADIT balance given the circumstances upon which it was made.

Rather than attempt to support its ADIT recommendation with any basis, let alone one which is supported by an accounting and/or a regulatory authority, the Company prefers to reach another unsupported conclusion that RUCO's analysis is contrary to the Statement of Financial Accounting Standard ("SFAS") 109. Brief at 8. In fact, SFAS 109 supports RUCO's methodology in this situation. In relevant part, SFAS 109 provides:

> The consolidated amount of current and deferred income for a group that files a consolidated tax return **shall be allocated among the members of the group** when those members issue separate financial statements. **This Statement does not require a single allocation method.** The method adopted, however, shall be systematic, rational,

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[1] The nature of the utility business "almost unfailingly" creates net deferred tax liabilities. RUCO-12 at 4.

> and consistent with the broad principles established by this statement...
>
> Examples of methods that are not consistent with the broad principles of this Statement include:
>
> a. A method that allocates **only current taxes payable to a member of the group that has taxable temporary difference.** [emphasis added]

SFAS 109 provides for an allocation method in instances where a parent company's subsidiary issues separate financial statements. SFAS 109 specifically lists as contrary to its "broad principles" a method that considers only current taxes payable –i.e. not deferred taxes – such as the Company's original recommendation. RUCO's methodology is fair, rational and results in an accurate ADIT balance. The Commission should adopt RUCO's ADIT recommendation.

WORKING CAPITAL

The Company claims that because RUCO's calculation of a negative working capital is "too speculative," the Commission should reject it and adopt Staff's recommendation (which the Company joins) of zero working capital. Brief at 9. Staff testified that when considering working capital it is inequitable to ignore a major component of the working capital analysis and selectively recognize other components. S-9 at 22 and 24. Yet Staff, in arriving at its zero working capital recommendation has undertaken no analysis and ignores every component of a working capital analysis in lieu of a general policy of recommending zero for working capital. Transcript at 433.

Even the Company admits its original recommendation of a positive working capital allowance using the formula method was inappropriate **because of the Company's practice of billing in advance**. Brief at 8. No party disputes that the Company's practice of billing in advance results in revenue lags. The Company's due date, when compared to the mid-point of the service period of the 15th, yields a revenue lag of approximately seven or eight days. RUCO-11 at 13. To arrive at its recommended expense lags, RUCO used the same inputs that the Company's used in its formula method by which the Company arrived at a positive working capital[2]. Transcript at 429. The Company, however, is now critical of RUCO's use of the Company's recommended expense lags as being "speculative." The Company's argument is irrational and should be rejected by the Commission.

RUCO prepared and utilized a lead-lag study to arrive at its cash working capital recommendation. Transcript at 429. Since a cash working capital allowance can only be negative where the revenue lag is shorter than the expense lag, RUCO has proven, in this case, beyond a doubt that the cash working capital allowance should be negative. Moreover, to arrive at a zero cash working capital requirement, Staff would have had to ignore the revenue lag or come up with an expense lag of less than 7.83 days (which as RUCO has shown is not possible – See RUCO's Closing Brief at 12). Transcript at 431. The Commission should adopt RUCO's recommended cash working capital.

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[2] 45 day lag for O&M and 15 day lag for purchased power. RUCO-11 at 13.

PROPERTY TAX EXPENSE

The Company states that the ADOR methodology using historical inputs ("ADOR methodology") has been repeatedly rejected by the Commission. Brief at 11. It is true that the Commission has rejected the ADOR methodology. Nonetheless, RUCO has repeatedly shown that the ADOR methodology is the most accurate estimate of the Company's property tax. In this case, as in others where the actual tax figures for the test year are known, the ADOR formula is consistently more accurate than the Company's methodology. Here, using the Company's as well as Staff's methodology, property taxes for 2005 would have been overstated by $13,796, which would have allowed the Company to over earn for several years until that level of tax was actually assessed. The Commission should reject the Company's and Staff's recommended property tax calculation and accept RUCO's recommended property expense.

RATE CASE EXPENSE

The Company requests $150,000 in rate case expense. In support of its position, the Company has provided an itemization of its rate case expense for the first time in its Closing Brief. See Brief, Exhibit 3. The Company is critical of RUCO's recommendation of $120,000 which is what the Company originally estimated would be its rate case expense. The Company believes RUCO's recommendation is fatally flawed because according to the Company, the only basis for RUCO's recommendation is that the Company should be held to its original estimate. Brief at 12. The Company's selective misinterpretation of the record for the purpose of misstating the basis upon which RUCO relied in making its recommendation does little, if anything, to show why the Company's recommendation is reasonable. In fact, a review of the record and what the Commission normally looks at when deciding what is reasonable makes it clear that the Company's rate case expense is not reasonable and should be rejected by the Commission.

The Commission typically looks at a variety of factors when considering rate case expense. Those factors include the complexity of the proceeding, the number of systems involved and a comparison of other cases. See for example Decision No. 67093 (Arizona-American's Sun City et al. rate case), Decision No. 66849 (Arizona Water Company). RUCO took all of these factors into consideration when determining what would be a reasonable amount of rate case expense. Transcript at 603-604. RUCO also took into account the fact that Algonquin was new to the rate making arena in Arizona and would incur rate case expenses that it would otherwise not incur with experience. Id. at 604.

In terms of complexity, the subject case is not complex. There are no contentious issues requiring an abnormal level of discovery, investigation, documentation, post-hearing expenses, or litigation and/or settlement expenses. There is only one system involved.

The Company claims that most of the rate case process is out of its control and that the best evidence of rate case expense is the amount actually incurred. Brief at 13. This argument is absurd. The Company chooses the issues it wants to litigate and the outside consultants it wishes to retain. The Company determines its approach to discovery requests and measures to mitigate expenses related to discovery.[3]

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[3] Staff notes that the Company used "delay tactics" in its approach to discovery which increased Staff's amount of discovery. Staff's Closing Brief at 21.

Moreover, the argument that the best evidence of rate case expense is the actual expense is self serving and misses the point. The Commission has made it clear that it is only going to award a reasonable amount of rate case expense. See Decision No. 67093 at page 20 - "Based on our review of the complexity of this proceeding, the number of systems involved in this rate request, and a comparison of other cases, we find that rate case expense in the amount of $418,941 is <u>*reasonable*</u> for this proceeding" Emphasis added. In other words, the actual costs must be reasonable for Commission approval. Here, the Company is asking for $6,787.50 for "Miscellaneous" costs. Brief – Exhibit 3. The Company has not described or itemized the costs and apparently expects the Commission to take its words that these costs are necessary. This is not reasonable. Next, the Company is requesting $12,143.85 for "Copying, printing, and CD duplication." Id. This does not include the transcript for which the Company is requesting $2,227.50. On its face, this large amount for copying is not a reasonable request for a case of this size. The Company is further requesting $1,665.60 for Mr. Bourassa's "Meals, Travel and Parking." Ratepayers should not have to reimburse Mr. Bourassa for his meals, travel or parking.

Finally, the Company makes a point that its actual rate case expense through July 31, 2006 is just over $194,000, however, it has elected to "cap" its request at $150,000. Brief at 12. Further to this point, the Company notes that its shareholders will absorb a substantial amount of rate case expense. Brief at 13. This argument is a red-herring and an attempt by the Company to support its recommendation by suggesting that ratepayers are somehow getting a good deal because ratepayers will not have to pay the full amount of rate case expense incurred by the Company. In truth, this argument is indicative of the Company's poor business sense and its failure to gauge what a "reasonable" amount of rate case expense should be in a rate case of this size. The Commission should adopt RUCO's recommended amount of rate case expense.

RATE DESIGN

The Company and Staff are recommending the termination of the Company's hook-up fees and the issuance of a refund to ratepayers. Brief at 29 - 30. RUCO opposes the termination and refund of hook-up fees. Transcript at 390. The purpose of hook-up fees is to defray the cost of growth from rates. Id. Companies typically accumulate hook up fees and apply the fees towards the cost of new plant and/or capacity when it becomes needed. This proposal of accumulating hook up fees and refunding them is contrary to the spirit of why the hook up fees were collected in the first place - to defray costs of future plant. Moreover, the Company will undoubtedly have a use for the accumulated hook up fees in the future and the hook up fees will then serve the purpose for which they were intended – defraying costs and lowering rates. Transcript at 390. The Commission should reject the Company and Staff's proposal to terminate and refund the hook-up fees.

COST OF CAPITAL

RUCO recommends the Commission adopt its recommended 9.49 percent return on common equity for Black Mountain. RUCO's recommended cost of common equity meets the standards set forth in the landmark U.S. Supreme Court cases of *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679, 692-93 (1923); and Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)*; which were later upheld in the more recent case of *Duquesne Light Co. v.*

Barasch, 488 U.S. 299, 314-15 (1989). RUCO's cost of capital witness, William Rigsby, has derived RUCO's cost of common equity recommendation from a sample of water utilities that face the same types of risk that the Company faces. Mr. Rigsby's recommendation is appropriate when the current environment of relatively low inflation and historically low interest rates that the Company is presently operating is taken into consideration. RUCO's recommendation will, assuming that the Company is efficiently and economically managed, provide Black Mountain with a return on investment that will instill confidence in the Company's financial soundness, allow it to attract capital and allow it to perform its duty to provide service to ratepayers. RUCO-14 at 7.

The Company argues in its Brief that it is disadvantaged because it operates in Arizona where the Commission applies an historic test year. Brief at 18. The Company ignores the fact that Black Mountain's parent Company, Algonquin, has acquired by choice no less than five water and wastewater systems in the Arizona jurisdiction over the past five years. RUCO 14 at 3. Algonquin, an open-ended investment trust that is publicly-traded on the Toronto Stock Exchange, which owns or has interests in a diverse portfolio of power generating and infrastructure assets across North America (including 48 hydroelectric facilities, five natural gas-fired cogeneration facilities, 18 alternative fuels facilities and 15 water reclamation and distribution facilities), is no "babe in the woods" when it comes to performing the due diligence needed to make decisions on the acquisition of utilities such as Black Mountain and the types of regulatory environments that they operate in. It does not make sense that a sophisticated company, such as Algonquin would acquire any of the Arizona water and wastewater systems that it now owns if it believed it was going to have to face a harsh regulatory environment.

The Company argues that RUCO's cost of equity is to low given the Company's size. RUCO-13 at 26. The Company's argument is misplaced. The Company ignores the great size and financial strength of its parent, Algonquin, which is publically traded on a major stock exchange. Id. at 26-27. Moreover, Algonquin owns 100% of the Company and has easy access to the capital markets. Id. The Commission has consistently rejected the argument for a risk premium based on company size where a financially sound parent exists, and should do so in this case. Id.

RUCO further recommends that the Commission adopt one of RUCO's two recommended hypothetical capital structures. Depending on the Commission's final decision on the Scottsdale treatment capacity issue, RUCO's recommended capital structures provide a weighted cost of capital that takes into account either the inter-company debt that was on the Company's books during the test year or the cost of debt that was reported by Black Mountain's parent, Algonquin, during the same operating period. RUCO-15 at 10-11. In its Brief, the Company agrees that Mr. Rigsby's hypothetical capital structure, which includes the aforementioned inter-company debt, should be adopted by the Commission if the Commission chooses to adopt RUCO's recommendation to rate base the Company's Scottsdale treatment capacity costs. Brief Page 19.[4]

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[4] The Company's Brief mistakenly refers to Mr. Rigsby's second capital structure option of 43 percent debt and 57 percent common equity, which RUCO recommends if the Commission were to adopt the Company's position on the Scottsdale treatment capacity issue. Brief at 19. The Company references RUCO's surrebuttal testimony on cost of capital, which Mr. Rigsby corrected on the stand during the evidentiary hearing. Id., Transcript at 539. In order to avoid any further confusion on this point, the capital structure recommendations exhibited in Schedule WAR-1 of Mr. Rigsby's direct testimony are the capital structure recommendations that RUCO continues to recommend for Black Mountain. RUCO-14, Schedule WAR-1.

RUCO takes issue with the Company's argument that in estimating the cost of equity, RUCO has blindly applied the results obtained from the DCF and CAPM stock valuation models. Brief at 20. Quite the contrary, it is the Company's witness who relied entirely on it's analyst's growth estimates at face value. Id. RUCO's DCF model used Mr. Rigsby's objective estimates of external growth ("sv") using Value Line analyst's projections as a guide. RUCO-14 at 25-26. Black Mountain's cost of capital witness was unable to accurately calculate sv estimates for Connecticut Water Service, Inc., Middlesex Water Company and SJW Corp., because of the lack of forward-looking projections on share growth for those utilities. Instead of eliminating those water utilities from his analysis, the Company's witness simply substituted an average of his growth estimates for the other three water utilities in his sample that do have the aforementioned share growth information. RUCO-14 at 64.

RUCO also takes issue with the Company's continued criticism of Mr. Rigsby's sv calculation, which recognizes that the market price of a utility's common stock will tend to move toward book value, or a market-to-book ratio of 1.0, if regulators allow a rate of return that is equal to the cost of capital. RUCO 15 at 19-20. This assumption is valid and was explained fully by Mr. Rigsby in his pre-filed testimony. RUCO-14 at 17-18, RUCO 15 at 18-20. The same methodology used by Mr. Rigsby's to calculate external growth was used by the Commission in deriving the cost of common equity in the Southwest Gas rate case recently decided by the Commission. RUCO-14 at 17 - 18.

The Company's CAPM analysis should also be rejected. The Company's cost of capital witness is critical of the CAPM and its use by Staff and RUCO in this case, and believes that its risk premium methodology should be relied on instead. Brief at 28. The risk premium method is nothing more than an offshoot of the CAPM model that does not take into consideration the additional market based information that is part of the CAPM model. The Company's conclusion that a rate of return should be higher simply because the CAPM is producing higher results at this particular point in time ignores other necessary factors. The expected rate of return produced by the CAPM model, and also by the risk premium approach, is just one of a number of factors that investors take into consideration when evaluating a utility's stock. Transcript at 582-584. Despite the fact that updated Value Line projections indicate lowered expectations for returns on common equity for water utility stocks, the Company's witness has made no downward revision to his original 11.00 percent estimate. Transcript at 141-142.

RUCO's cost of capital recommendations for Black Mountain are well-reasoned, reasonable, fair, and should be adopted by the Commission.

CONCLUSION

RUCO recommends that the Commission treat the Scottsdale capacity as an asset and include it in the Company's ratebase. RUCO further recommends that the Commission decrease the Company's ratebase by $161,250 to include Black Mountain's allocated portion of ADIT, adopt RUCO's recommended negative cash working capital allowance, adopt RUCO's adjustment to property tax expense, capitalize the Company's legal expenses associated with the operating agreement with the Town of Carefree and the expenses related to training on safety equipment. RUCO also recommends the Commission adopt the Company's current rate design with adjustments to generate RUCO's recommended level of revenue and reject the Company and Staff's recommendation to terminate and refund hook up fees, approve rate case expense of $120,000, and adopt RUCO's reduction to income tax expense of ($31,808).

Finally, RUCO recommends the Commission adopt its 9.45% weighted average cost of capital if it adopts the Company's pro forma Scottsdale capacity position and 8.92% if the Commission rejects the Company's pro forma Scottsdale capacity.

RESPECTFULLY SUBMITTED this 5th day of September 2006.

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